Supreme Court of the United States

BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 793

MARK E. SCHLUDE and MARZALIE SCHLUDE

v.

COMMISSIONER OF INTERNAL REVENUE

BRIEF AMICUS CURIAE OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

STATEMENT OF INTEREST OF THE INSTITUTE

The American Institute of Certified Public Accountants is a nation-wide professional organization of more than 42,500 certified public accountants out of a total of approximately 70,000 in the United States. It is a non-profit organization chartered under the laws of the District of Columbia, and is the only national professional organization of certified public accountants. Its membership embraces certified public accountants from every state and territory, and from the District of Columbia and Puerto Rico.

The Institute and its members have a profound interest in maintaining a proper relationship between accepted accounting principles and accounting for tax purposes. They believe the Petition should be granted because the Court of Appeals for the Eighth Circuit has erroneously construed and applied this Court's decision in the *American Automobile* case in a manner that will have a far-reaching and adverse impact upon many taxpayers who report income on an accrual basis. Review of the decision in the *Schlude* case, the Institute believes, is of importance to assure the proper administration of the federal income tax laws and to avoid unnecessary confusion, uncertainty and litigation that may otherwise develop in the field of tax accounting by accrual basis taxpayers. The Institute, accordingly, submits this brief *amicus curiae* in support of the Petition for a Writ of Certiorari in the *Schlude* case and urges that the Writ be granted for the reasons set forth below.

The consent of the parties to the filing of this brief *amicus curiae* has been filed with the Clerk of the Court.

OPINIONS BELOW, JURISDICTION AND STATUTES INVOLVED

The Institute respectfully refers the Court to the Petition of the taxpayers for the statement of the Opinions Below, Jurisdiction and Statutes Involved.

QUESTION PRESENTED

The question presented is: When an accrual basis taxpayer's method of accounting accurately matches revenues derived from services performed in the tax year with related costs, does the decision in *American Automobile Association* v. *United States*, 367 U.S. 687,

authorize the Commissioner to tax as income the entire face value of long term executory service contracts in the year such contracts are signed although a large portion of amounts received under the contracts has not yet been earned and an even larger portion of the face value of the contracts has been neither received nor earned?

STATEMENT

Petitioners operated a partnership that provided dance instruction services. The students paid a portion of the face value of contracts entered into with the partnership when the contracts were signed and promised to pay the remainder thereafter in installments (R. 108-111, 121-122, 207).[1] The contracts giving rise to the income here in question ran for a term greater than an annual tax year (R. 115, 208).[2] Although the contracts bound the partnership to perform the required services, the dates for each hour of instruction were not scheduled in the contracts but were agreed to from time to time with the student as individual lessons were given (R. 186-187, 207-208). Each contract how-

[1] "Under some contracts a student made all subsequent payments directly to the partnership. Under another type of contract the student made a part of the subsequent payments to the partnership and another part, evidenced by the student's negotiable note, to a bank to which the partnership had transferred the note. Upon such transfer, the bank deducted interest charges, paid approximately 50 percent of the balance of the note to the partnership and retained the remainder in a reserve account which the partnership could not draw upon until the student had paid the note in full (R. 108-111, 122-123, 208)."

[2] "R. ——" references are to the record before the Court of Appeals below on appeal from the decision of the Tax Court, a copy of which was filed in this Court on March 15, 1962, together with the Petition for a Writ of Certiorari.

ever, provided a period certain before the expiration of which all the hours of instruction contracted for were required to be taken, and the partnership followed the practice of cancelling any contract under which no instruction had been requested by a student for one year (R. 108-111, 154, 210).

Although each contract contained a clause prohibiting the student from cancelling the contract and thereby avoiding payments thereunder, in fact almost 20 percent of the contracts were cancelled in the tax years 1952, 1953 and 1954—the years here in issue (R. 197, 215). The partnership, moreover, was frequently compelled to reduce the hours of instruction—and, accordingly, the payments due—under other contracts in order to avoid cancellations (R. 153, 208).

The partnership has always used an accrual method of accounting that had been designed by a certified public accounting firm to match the partnership's revenues derived from services rendered under each contract in the tax year with costs of performing such services. As each contract was signed, the total contract price was credited to a "deferred income" account. Individual student record cards were maintained that identified each student, the type of contract, hours involved, total contract price, and the hours of instruction given and payments made under the contract. At the end of the partnership's tax year, the card for each student was reviewed, and the amount of income earned under each contract was determined by multiplying the number of hours of instruction given by the rate per hour on that contract. The "deferred income" account was then reduced by that

amount and an "earned income" account increased by the same amount. Earned income from all contracts was totalled and was reported as income on an accrual basis in the partnership's tax return for that year (R. 146-149, 209-214).[2]

Contending that the entire face amount of each contract constituted income to the partnership in the year the contract was signed, the Commissioner rejected the partnership's accounting system for tax purposes and instead increased the net income of the partnership for each of the tax years 1952, 1953 and 1954 by some $21,000, $405,000 and $133,000—the total increase in the "deferred income" account for each such year (R. 213-215). On this basis, he determined deficiencies against the taxpayers for these years of some $18,000, $83,000 and $11,500, respectively (R. 204). The Tax Court, three judges dissenting, sustained the Commissioner's ruling. It held that the entire face value of each contract was income in the year it was signed, although in that year a large portion of payments made by the student was as yet unearned by performance and an even larger portion of the face value of the contract remained both unpaid and unearned (R. 215).

The Court of Appeals for the Eighth Circuit reversed and held that the accrual accounting system used by the partnership was "eminently designed to reflect true income" (Pet. App. B, p. 13a). This Court thereafter granted a Writ of Certiorari, vacated the judgment of the Court of Appeals and remanded the case to that court "for further consideration in light

[2] Any gain arising from the cancellation of a contract by a student (or by the partnership where no instruction had been given for a year) was likewise reported as income on the tax return (R. 153-154, 210).

of *American Automobile Association* v. *United States*, [367 U.S. 687]." See 367 U.S. 911 and 368 U.S. 873. On December 15, 1961, the Court of Appeals rendered a *per curiam* opinion affirming the decision of the Tax Court. Citing nothing more than the *American Automobile* decision, the court stated: "In light of that case we have carefully examined and considered petitioners' method of accrual accounting and are convinced that such method does not, for income tax purposes, clearly reflect income." (Pet. App. A, p. 2a.)

REASONS WHY THE INSTITUTE BELIEVES THE WRIT SHOULD BE GRANTED

THE DECISION BELOW SERIOUSLY MISINTERPRETS THIS COURT'S *AMERICAN AUTOMOBILE* DECISION

The decision below represents a wholly unwarranted departure from this Court's decision in *American Automobile Association* v. *United States*, 367 U.S. 687. There this Court sustained the Commissioner's authority to reject for income tax purposes an accrual accounting system which, the Court ruled, deferred the reporting of income to subsequent years without precise regard to expenses incurred by the taxpayer in exchange for receipts paid to it. In the *Schlude* case, the court below, relying solely on the *American Automobile* decision, upheld the Commissioner's rejection of what the Institute believes to be a most accurate accrual accounting system that precisely matched revenues derived from services performed in the tax year with the cost of performing such services. Further, and certainly more important from the taxpayers' point of view, *American Automobile* involved the taxation only of advance receipts; it did not tax unreceived and unearned income. Nevertheless, that decision was applied in *Schlude* to tax the entire contract price of

long term executory service contracts as current income in the year such contracts are signed even though the taxpayer can neither receive nor earn the contract price except by performing services in subsequent tax years. These rulings, which constitute the holding below, conflict with established accounting principles and with the law of the *American Automobile* decision.

A. THE COURT BELOW IMPROPERLY HELD THAT THE *AMERICAN AUTOMOBILE* DECISION DOES NOT PERMIT THE USE FOR TAX PURPOSES OF ACCOUNTING PROCEDURES THAT ACCURATELY MATCH INDIVIDUAL ITEMS OF REVENUE WITH COSTS AS INCURRED.

1. The court below has interpreted this Court's decision in the *American Automobile* case to mean that established procedures of accrual accounting, which accurately and precisely match revenues derived from services performed in the tax year with related items of cost, may no longer be used by accrual basis taxpayers for income tax accounting purposes. The Institute believes that this sweeping result is contrary to the decision in the *American Automobile* case.

The error committed below had its beginning in the court's failure to recognize the substantial and significant distinctions that exist between the system of accrual accounting in the *American Automobile* case and that here involved. The taxpayers in *Schlude* had consistently, since the inception of their business, relied upon accepted accounting principles to report as income for federal tax purposes amounts which the taxpayers had actually earned in performing the services under their contracts. There was recorded on a card for each student the number of hours of instruction given to him in each tax year. Income reported under each contract was determined by mul-

tiplying the hours of instruction given by the hourly rate applicable to such contract. The income was thus reported in each tax year precisely to the extent it was earned by the partnership in fulfilling its contract with each student that year, as reflected in these records (R. 146-149, 209-214).[3] This accomplished an appropriate matching of revenues and costs since costs were incurred in the period in which the services were rendered.

In the *American Automobile* case the taxpayer was unable to rely upon a comparably precise and detailed method of ascribing membership dues it received from individual members all of which the members paid in advance, to the period when actual costs of performing its services were incurred. The accounting system there required only that a ratable portion of these total advance receipts be reported as income for tax purposes on a month-by-month basis over the membership period, without regard to the actual cost of services rendered to each member. 367 U.S. at pp. 688, 690. For this reason, the Court considered the *American Automobile* case controlled in essential respects by *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180, 189, which upheld the Commissioner's rejection for income tax purposes of substantially the same accrual accounting system because recording the accrual of the membership dues paid to the tax-

[3] All revenue received or receivable was reported in the appropriate tax year, and there was thus no avoidance of taxable income by the taxpayers. The taxpayers' established accounting practice was also to report as income all cash amounts received greater than income earned by performance on contracts that were cancelled by students or contracts under which no instruction had been given for one year (R. 153-154, 210). Further, each contract required that all the lessons thereunder be taken in a time certain (R. 108-111).

payer "in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the members."

From an accounting point of view, therefore, both the *Michigan* and *American Automobile* cases turn on the fact that in recording the accrual of income for tax purposes in any year neither taxpayer could point to the portion of the membership dues that related to the expense of rendering services to individual members. They found it necessary to employ "statistical computations" reflecting the over-all estimated cost of services to all members on a group basis. This deficiency was deemed crucial by the Court in *American Automobile*. Thus, the Court characterized the accrual accounting system there used as one which caused earned income to be reported over the membership period "without regard to correspondingly fixed individual expense or performance justification" and which was not keyed to "the actual incidence of cost in serving an individual member" or "in fact related to the expenses incurred." 367 U.S. at pp. 692-693.[1] In the *Schlude* case the taxpayers achieved exactly what the Court found was lacking in the automobile decisions.

The Institute urges that the *Schlude* petition be considered with the knowledge that the accrual accounting system there used accurately and precisely reflected income as earned as it accrued to those taxpayers. The taxpayers reported as income those receipts that were

[1] Reliance by the taxpayer upon over-all averages in accruing deductions for claims lodged against it also distinguishes the decision on remand in Milwaukee & Suburban Transport Co. v. Commissioner, 293 F. 2d 628 (7th Cir. 1961), *cert. denied*, 7 L. Ed. 2d 438 (January 22, 1962). See pp. 2-4 of the Memorandum for the Respondent in opposition to the Petition for Certiorari filed by the taxpayer in the Milwaukee case, No. 603, October Term, 1961.

exactly allocable to the "services . . . rendered"; they reported as much income as had been earned "through the fulfillment of [their] required performances" under each service contract. See *Tax Accounting and Generally Accepted Accounting Principles*, Committee on Accounting Principles for Income Tax Purposes of the American Institute of Certified Public Accountants, pp. 6-7 (1953); See also *Accountants' Handbook*, § 20, p. 8 (4th ed. 1956); Paton, W.A., "*Deferred Income*"—*A Misnomer*," J. Accountancy, p. 39 (Sept. 1961).[5] (The pertinent text of these authorities is set forth in the Appendix.)

The accounting procedures used in *Schlude* leave open only one conceivable objection of the many that have heretofore been made by the Commissioner. That relates to the claim that the long-term contracts did not definitely schedule the performance of services by the taxpayers in the tax years subsequent to the year a contract was signed. However, while no schedule was

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[5] The concern of the accounting profession is, of course, that business and other taxpayers use accounting procedures which reflect their true income, not only for tax purposes but for commercial, regulatory or personal needs, as the case may be. It is, therefore, as significant to the accountant that there be no overstatement of income as it is that there be no understatement of income. In Matter of C. Cecil Bryant, 15 S.E.C. 409, 402 (1944), the Commission permanently disqualified a certified public accountant from practice before it on grounds among which was:

> "The financial statements covered by the aforesaid certificate contained material misstatements and misrepresentations. For example, accounts receivable shown as 'not yet due' (representing the corporation's principal asset) were found to comprise items for the most part due or past due. In addition, substantial payments received by the corporation for services to be performed in future years were credited in their entirety to income when received, and the result was an overstatement of the income and surplus of the corporation."

set forth in the contracts, as each lesson was given the next lesson was scheduled (R. 186-187). In any event, the Institute believes that this factor alone should not be sufficient to determine whether the Commissioner shall be permitted to reject an accrual accounting system that satisfies accepted accounting principles in every respect and at the same time gives rise to no loss of federal revenues. To give dominance to this single and fortuitous aspect of any business, despite the fact that it is wholly insignificant from the standpoint of protecting the revenues, is not required by the Internal Revenue Codes of 1939 or 1954, or by decisions of this Court. Nor can it be justified by reason or common sense.

The Institute, as *amicus curiae*, therefore urges the Court to review the decision below so that accrual taxpayers may be apprised as to whether the *American Automobile* decision permits accrual accounting of advance receipts to be used for tax purposes where income is reported precisely and accurately as it is earned.

2. Putting to one side the need for review of the rejection of the precise and accurate accrual accounting system used in *Schlude*, the enactment and subsequent repeal by Congress of Sections 452 and 462 of the Internal Revenue Code of 1954 supply no support for the Commissioner's action. Despite the Court's reliance upon the legislative history of these Code sections dealing with prepaid income and reserves for estimated expenses, the Court's full consideration of the particular accrual accounting system at issue in *American Automobile* indicates that the Court's *holding* was only that the action of the Commissioner in rejecting that accounting system as inadequate was not unsound.

No other conclusion can be reached if the Court's lengthy review of the specific accounting system of the taxpayer in that case is not to be deemed superfluous. The Court's reliance upon the legislative history of the 1954 Code provisions, on the other hand, may be properly understood as a persuasive but not controlling ground upon which it upheld the Commissioner's rejection of the accrual accounting system in *American Automobile*.[6]

Moreover, whatever effect the Court intended to give to the legislative history of Sections 452 and 462, that effect should now be viewed in light of two subsequent developments in the area of accrual accounting for tax purposes. These developments are: *first*, the statements of committees of Congress in reports accompanying the enactment on July 26, 1961, of a new Section 456 in the 1954 Code which strongly suggests that in repealing Sections 452 and 462 in 1955, Congress did not intend to prohibit the use of all accrual accounting systems for advance receipts without regard to how accurately and precisely any such system

[6] Even if the Court's reference to the legislative history of Sections 452 and 462 constituted an alternative holding in the American Automobile case, this portion of the opinion should be construed as a reading of that legislative history only as it applies to the type of accrual accounting system used by the taxpayer in that case, in which over-all estimates and averages of costs and expenses are relied upon to determine reportable income. In discussing the legislative history, the opinion frequently referred to the effect of the legislative history upon "the [accounting] practice as was used by the [Automobile] Association here", and upon "the method used by the Association", 367 U.S. at pp. 694-95. The Court also referred to repeated unsuccessful attempts by the taxpayer in American Automobile to convince Congress to pass legislation which, in terms, would have authorized such taxpayers to use the very same type of accrual accounting system that was being reviewed by the Court. *Id.* at p. 696.

actually reflected earned income;[7] and *second*, the recent issuance by the Commissioner of Internal Revenue of regulations under Section 455, enacted in 1958 to govern taxation of income received in advance for newspaper and periodical subscriptions, which explicitly recognize that taxpayers who had previously been deferring the recognition of taxable income from such sources "under an established accounting method" may continue to do so without regard to the specific provisions of Section 455 itself or of the new regulations thereunder.[8] The Commissioner's regulations on Section 455 and the committee reports accompanying the new Section 456 appear to acknowledge that the use

[7] New Section 456 allows membership organizations such as the taxpayer in American Automobile to report income over an accrual period greater than an annual tax accounting year as it is earned in performing the services for which their members pay dues. The congressional reports state that "Congress recognized in the committee reports" accompanying the bills repealing Sections 452 and 462 in 1955 "the desirability of following generally accepted accounting principles for reporting income for tax purposes," and that the two sections were repealed because "Congress became aware of the fact that a large revenue loss was involved" in the "first years of [their] application." H.R. Rep. No. 381, 87th Cong., 1st Sess., p. 2 (1961); S. Rep. No. 543, 87th Cong., 1st Sess., p. 2 (1961).

[8] Regulations § 1.455-5(d) reads:

"Treatment of prepaid subscriptions income under an established accounting method. Notwithstanding the provisions of section 455 and § 1.455-1, any taxpayer who for taxable years beginning before January 1, 1958, has reported prepaid subscription income for income tax purposes under an established and consistent method or practice of deferring such income may continue to report such income in accordance with such method or practice for all subsequent taxable years to which section 455 applies without making an election under section 455." (Promulgated as Treasury Decision 6591, February 22, 1962.)

of accrual accounting methods was permissible for tax purposes before the enactment of Sections 452 and 462 and was not affected by their repeal in 1955.

(B) THE COURT BELOW MISAPPLIED THE *AMERICAN AUTOMOBILE* DECISION IN HOLDING SUBJECT TO TAX PORTIONS OF THE FACE VALUE OF SERVICE CONTRACTS WHICH HAD BEEN NEITHER RECEIVED NOR EARNED

What has been said so far has had to do with the Institute's professional concern over the mischief that the *Schlude* decision does to the use of precise and accurate accepted methods of accounting for tax purposes. The error committed below is made even more graphic when one considers that the court also found the *American Automobile* decision to be authority for a proposition with which that decision did not even purport to deal, *i.e.*, that the *unearned future contract receipts* of an accrual basis taxpayer are taxable in the year the contract is signed.

The *Schlude* taxpayers' business was conducted to a very large extent on the basis of executory service contracts under which a student made a down payment and promised to make future payments during the life of the contract, which extended into subsequent tax years (R. 122-123, 148, 208). This situation is essentially the reverse of that in *American Automobile*, where the business was conducted on the basis of amounts actually prepaid by customers. 367 U.S. at p. 690. Nevertheless, the court below, relying entirely on *American Automobile*, affirmed the Commissioner's determination that the entire contract price of each contract was to be reported as income by the taxpayers in the tax year in which the contract was entered into, including that part of the price representing payments to be made in subsequent years.

The court below thus wholly disregarded a fundamental distinction between accrual taxpayers who have received advance receipts, on the one hand, and such taxpayers whose performance and receipts are postponed to subsequent tax years, on the other. The result was a misapplication of the *American Automobile* ruling in a further respect that will be of far greater impact upon accrual basis taxpayers than any decision affecting tax accounting for advance receipts alone.

1. Wholly apart from any question of the adequacy under accounting principles of accounting methods used by accrual taxpayers such as *Schlude*, the *American Automobile* decision can not be read to authorize the Commissioner to require the reporting as income under long-term service contracts of the entire contract price in the year in which the contract is signed. Nothing in the *American Automobile* decision sustains such a result. The taxpayer there always received in advance funds paid by its members as dues and in return for which the taxpayer became obligated to perform services. These funds were immediately available to the taxpayer for its unrestricted use.

In the *Schlude* case, not only were many payments under the service contracts to be made in subsequent years, but, the record discloses, there was no assurance whatsoever that such subsequent payments would in fact be made. A large number—almost 20 per cent—of the service contracts were cancelled or defaulted by the students; others of the contracts were required to be rewritten for a smaller number of lessons than had been contracted for initially, in order to persuade students not to cancel or default entirely on the contracts (R. 153, 197). And, the cancellations and defaults took place, and the rewriting of contracts for

shorter periods was necessary, even though each contract contained a clause providing that it was noncancellable (R. 108-111). In these circumstances, it is apparent that the taxpayers could by no means expect that they would ever receive the unpaid portion of a long-term contract signed by a student.

The only case cited to the court below by the Commissioner in support of his action was *Commissioner* v. *Hansen*, 360 U.S. 446.[9] *Hansen* is, however, inapposite here since the accounting method used by the taxpayers in the *Schlude* case for unpaid portions of the service contracts did not result in deferring the recognition of income which those taxpayers had a "fixed right to receive," as was the case in *Hansen*. *Id.* at p. 464.

In *Hansen* the accrual basis taxpayers had fully performed their obligations under contracts with customers—by delivery of vehicles that had been sold—and had accordingly earned all of the contract price. See *id.* at p. 448. For this reason it was of no significance for tax purposes that a part of the contract price was being held in reserve accounts for the taxpayers by their financing organizations and would not be paid to them in cash until subsequent tax years. The amounts held in reserve had been as much earned by those taxpayers as the amounts actually paid in cash to them as down payments by car buyers and the amounts paid by the financing organizations, to whom the taxpayers sold the negotiable notes of the car buyers for the balance of the contract price. In *Schlude*, on the other hand, substantial portions of the contract remained not only unpaid when signed, but

[9] Supplemental Memorandum for the Respondent on Remand to the Court of Appeals in Schlude v. Commissioner (pp. 6-8).

also remained unearned by the taxpayers until they performed the services the contracts called for.[10] Simply stated, the unpaid amounts were amounts which the *Schlude* taxpayers would have a "fixed right to receive" only as they performed services.

Not only may no support be gleaned from the *Hansen* and *American Automobile* decisions for this aspect of the decision below, but as a matter of simple justice it cannot be that the entire unpaid and unearned portion of the face value of a service contract for a term of years may be taxed as income in the year the contract is signed. Such a result is improper and arbitrary; it has no more justification than would the taxation of all future interest coupons on a bond, or of all future unpaid rental under a lease, in the year in which the bond is purchased or the property leased.

2. The improper extension of this Court's *American Automobile* decision by the court below to amounts not yet received would be remedied if this Court were to decide that the *Schlude* taxpayers' accrual accounting system was proper for tax purposes under *American Automobile*.

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[10] It would, of course, be equally improper to equate the situations of the taxpayers in the Hansen and Schlude cases merely because in both proceedings the taxpayers discounted with financing organizations all or part of long-term contracts on which amounts remained unpaid. See p. 3 n. 1 above. The fact that in both cases the financing organizations withheld a portion of the discounted value of the contract in a "reserve account" should be no more determinative of when the Schlude taxpayers received reportable income than is the fact that the bank actually paid them 50 percent of the unpaid portion of the contract in cash immediately. The test in each instance should be: what portion of the cash payments or of the reserve accounts—like payments made by students to the taxpayers directly—was earned in any tax year.

The taxpayers' accounting method in *Schlude* was as accurate in determining income in a tax year for the unpaid portions of the service contracts as it was for the portions as to which the taxpayers received advance receipts. Under the accounting procedures that were followed, the taxpayers simply reported all income precisely as it was earned under each contract through their performance of services in each tax year, without regard to whether cash amounts allocable to the taxpayers' performance might or might not have in fact been paid by a student. It was thus possible that the taxpayers would have reported income under a long-term contract as to which they had performed more services than they had actually been paid for in cash. This result, of course, is proper under accrual accounting, and can not be objected to by accrual basis taxpayers, for the reason that income in such a case has been "earned"—that is, properly accrued—by the taxpayer. See, *e.g.*, *Continental Tie & L. Co.* v. *United States*, 286 U.S. 290, 295-296; *Beacon Publishing Co.* v. *Commissioner of Internal Revenue*, 218 F. 2d 697, 699 (10th Cir. 1955). The *Schlude* taxpayers' objection, therefore, and the concern of the Institute, is not merely that there should be no taxation of unpaid portions of contracts in the year the contract is signed because the taxpayers have received no cash amounts as to such unpaid portions, but more importantly, that the unpaid portions of contracts should not be taxed until the time the taxpayers' performance of services earns income.

3. The construction of the *American Automobile* decision by the court below will have a severe impact upon all accrual basis taxpayers who agree to perform services or produce goods in the future in return for a buyer's promise to pay. There is no satisfactory basis

upon which that construction may be narrowed to the facts of the *Schlude* case. The decision of the Tax Court, which became in effect the decision of the Court of Appeals, was that the fixed and unconditional right of the studio to "receive" the full price of a long-term contract arose at the time the contract was entered into (R. 215). The Tax Court's ruling in respect of the unpaid portions of the contracts, therefore, did not rely upon such considerations as the accuracy of the taxpayers' accounting system, the fact that the services the taxpayers were to perform in subsequent years were not scheduled for fixed times, or any other factors that were treated in this Court's *American Automobile* decision. Accordingly, because this aspect of the *Schlude* ruling necessarily will have broad application in the future to a variety of different business and accounting contexts, the Court should review the decision and determine whether it shall continue to govern the tax accounting practices of the many accrual basis taxpayers whom it affects.

CONCLUSION

For the foregoing reasons, the Institute urges that the Petition for a Writ of Certiorari in *Schlude* v. *Commissioner* be granted.

Respectfully submitted,

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March 19, 1962.

APPENDIX

Pertinent Text From Accounting Authorities

Tax Accounting and Generally Accepted Accounting Principles, Committee on Accounting Principles for Income Tax Purposes of the American Institute of Certified Public Accountants, pp. 6-7 (1953):

"The process of matching or properly assigning revenues and expenses to an accounting period involves recognition of revenue which has been earned but has not yet been received and of expense which has been incurred but has not yet been paid; it involves the deferring or carrying forward as a charge against the future of some expenditures which have been incurred or paid, and the deferring or carrying forward to future periods of certain revenues which have been received.

"The fundamental generally accepted accounting principles which govern the treatment of revenues, costs and expenses falling within the areas of divergence under consideration may be stated briefly as follows:

"1. Revenues are recognized as entering into the determination of income when sales are made or services are rendered.

"2. The mere receipt of money or promise of another person to pay money for goods or services does not represent revenue which should be recognized in the determination of income of the period of receipt if it is burdened with an obligation to deliver goods or render services in the future. Items of this nature are treated as resulting in liabilities or deferred credits until they are earned through the fulfillment of the required performances. However, the fact that incidental costs or claims are yet to be met does not warrant deferring recognition of revenues; for example, revenues from sales are recognized despite the fact that they are subject to product guarantees or sales allowances. These incidental costs and allowances are deemed to be charges of the period in which the revenues are taken into income."

Accountants' Handbook, § 20, p. 8 (4th ed. 1956):

"DEFERRED REVENUES. Advances by customers or clients which are to be satisfied by the future delivery of goods or performance of service are liabilities and should be shown as such. These items have often been labeled 'deferred revenues' or 'deferred credits,' and occasionally are classified on the equities side of the balance sheet between liabilities and proprietorship. Such titles are inclined to be misleading, and such classification is unwarranted. The essential peculiarity of such accounts lies in the fact that they are payable in goods or services rather than in cash, and that as a rule a margin of profit will emerge in making such payment. Under no circumstances should these items be offset against outstanding receivables; nor should they be recorded as earned income prior to delivery of goods or rendering the service for which advance payment has been received."

Paton, W. A., "*'Deferred Income'—A Misnomer*," J. Accountancy, p. 39 (Sept. 1961):

"If there is a major point upon which there is general agreement in accounting it is that revenue results from the over-all process of production, and not from borrowing or otherwise raising funds. Moreover, for most lines of business, revenue is regarded as recognizable when product is delivered to the customer. It is also axiomatic that net income, if any, is the amount by which total revenue for the period, represented by the sale value of the delivered product, exceeds all the expenses, losses, and taxes properly applicable to such total revenue. In the face of these basic considerations how can we justify using the word 'income,' even with the qualifying term 'deferred' attached, to describe the amount of a customer advance? Such an advance may be received before the process of production has even been started, before any costs have been incurred, and before anyone knows for certain that any 'income' will ever be realized on the particular operation or contract!"